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INNOVA
ASSET MANAGEMENT

INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS

THE MISUNDERSTOOD ROLE OF RISK TOLERANCE

Risk tolerance plays a central – yet often misplaced – role in the financial advice process.

It can help reveal an investor's character and the experiences that have shaped their outlook. It can provide a deeper understanding of how an investor is likely to behave in response to market volatility, helping rule out inappropriate investment products.

But inaccurate risk tolerance measures can also be misleading and override the importance of equally important benchmarks such as risk capacity and goal risk, which can give a more holistic view of a client's financial journey.

MANY RISK TOLERANCE MEASURES LACK SCIENTIFIC RIGOUR

While there is still debate about the best way to measure investment returns and risk, the underlying calculations are not in question[1]. Unfortunately, when it comes to risk tolerance measures, there is still little scientific analysis or consistency.

The **CFA Institute** found that using questionnaires to identify investor risk profiles is inadequate and unreliable, typically explaining less than 15% of the variation in risky assets between investors.

A 2015[2] report into Canadian and global risk profiling practices found at least 35% of Canadian client questionnaires included poor questions or scoring models, while at least 70% included scoring models that combined all factors into one arbitrary score. Only 11% of firms could confirm that their questionnaires (if they had one at all) were validated in some manner.

"There is a confusing and universal lack of existence or consistency of the definitions of risk concepts and a lack of understanding of the factors involved in risk profiling," the report said. "No group of stakeholders is immune from this problem, including academics, regulators and solution providers."

It is little wonder then that risk tolerance measures often fail to capture how people will behave in the real world, particularly during a significant market correction.

Behavioural biases, such as loss aversion, manifest themselves in complex ways while clients' 'stated preferences' often differ from their '**revealed preferences**', which shows how they will actually behave.

We know one adviser using Capital Preferences' **True Profile** tool (which we believe is one of the better risk profiling tools on the market because it incorporates a scientific approach

[1] *See previous Innova Insights:* '**Why it's possible to invest in a top performing fund manager and still lose money**' *and* '**It's time to include risk measures alongside super investment returns**'.
[2] '**Current Practices for Risk Profiling in Canada And Review of Global Best Practices**'. *Prepared for the Investor Advisory Panel of the Ontario Securities Commission by software provider PlanPlus. October 2015.*

that also recognises behavioural biases) and has compared it to typical client risk questionnaires.

He found some of his wealthy clients with $3-$5 million in assets had a much lower risk tolerance than typical questionnaires suggested because they could not withstand seeing such large real-world dollar losses. When confronted with the potential dollar value loss on their portfolios, these clients were actually much more loss averse than what their risk tolerance would suggest.

THE BIGGER PICTURE

Risk tolerance measures must be right, but they must also be used in the right way. Back in 2011, the Financial Services Ombudsman[3] **acknowledged** that there is no mandated method of risk profiling and it is only one tool to determine clients' tolerance to risk.

"Regardless of whether risk profiling tools are used or not, financial services providers must keep detailed records that show they secured their client's informed consent about the level of risk required to achieve their objectives," it **wrote**.

This is an acknowledgment that a client's attitude to risk can never be divorced from their goals. Risk tolerance needs to sit alongside goal risk (the risk that a client won't achieve their goals) and risk capacity (whether a client has the level of financial assets to take on those risks).

Balancing these factors is what good financial planning is all about.

For example, a client may need to take on more investment risk to achieve their goals but have a low risk tolerance. In this case simply placing all of this client's investable capital in a low risk portfolio would reduce the likelihood of achieving their goals (and may put the client in a worse outcome than they would have been without financial advice). This is where a good financial adviser can shine with true understanding and guidance.

Another example is a client who has plenty of investable financial assets and can easily achieve their goals. In this case, the client's investment strategy is more likely to be driven by their risk tolerance, as they do not need to take on risk to achieve their goals, but may wish to take on risk regardless to further grow their wealth.

A 2014 UK **study** found that more than half (52%) of respondents preferred to miss their savings goals than take investment risk[4]. Similarly, the 2017 ASX Australian Investor **Study** found a disconnect between investor risk profiles and return expectations with 81% of investors under 35 seeking guaranteed or stable investment returns.

Risk and return are forever intertwined but it is risk, and investor's responses to it, that often destroys goals. This is why Innova manages all aspects of risk to deliver a smoother and ultimately better long-term investment outcome.

Risk tolerance may play a central role in the advice process but it is just one component to help clients achieve their goals.

Contact Innova Asset Management for further information about our goals-based investment approach.

[3] *On November 1, 2018, the Financial Services Ombudsman was replaced with the Australian Financial Complaints Authority.*
[4] '**How Do Savers Think About And Respond To Risk?**' *Published by The Pensions Institute Cass Business School. David Blake and Alistair Haig*

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Sophie Temperton is the General Manager of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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